

2025 Early Childhood Education Funding Review Ministerial Advisory Group

Funding types and mechanisms for early childhood education

Purpose of the paper

1. The paper identifies, describes and assesses the broad approaches and different mechanisms that can be adopted by governments to fund early childhood services. It is intended to support the Early Childhood Education Funding Review Ministerial Advisory Group's (MAG) consideration of current funding mechanisms in use in New Zealand, the extent to which these (individually and collectively) support the purposes and the government's goals for ECE (as set out in the MAG Terms of Reference), and how the funding system is configured to support the purposes of ECE and the Government's goals.
2. The paper:
 - presents a broad organising framework (typology) for the different elements of funding systems, and the key funding approaches, types and mechanisms that can be used for funding ECE provision
 - applies this typology to the current New Zealand ECE funding system
 - discusses the alignment of different funding types with different objectives and considerations, including those outlined in the MAG Terms of Reference
 - identifies the pros and cons of different funding types
 - Provides an overview of health sector funding approaches, as an example of funding arrangements in sectors other than ECE
 - identifies key considerations and questions to take into account in considering the different funding types, individually and in combination.
3. This paper is intended to be high-level and is not intended to provide an exhaustive description of the many ways in which ECE funding can be designed and delivered. Within the broad typology presented, there are many nuances that it would be challenging to capture.
4. A separate paper provides a more detailed discussion of targeted funding approaches, including the key features and pros and cons of these approaches, and the way in which they are currently applied in New Zealand.

Key elements of funding systems

5. Funding approaches and types play an important role in supporting the achievement of the Government's goals and objectives for ECE.
6. There is a broad array of ways in which services such as ECE can be funded, but it's possible to identify some key funding 'types' (or models). This helps provide an organising framework for understanding the key features of the different funding types, and the circumstances and objectives for which they're most useful.
7. In this paper we distinguish between the overall funding system and the different types of funding that can be used to make up this system. We also identify several other dimensions of the funding system, such as the overall funding approach, and specific funding mechanisms that can be used to deliver funding.
8. The different layers of funding systems are defined and described as follows.
 - **Funding system** is the framework through which financial resources are allocated, managed, and distributed within the ECE sector. It includes all the components, such as

funding types, mechanisms, conditions and controls that determine how funding flows from government and other funders through to services and households. Each country will have its own unique funding system that reflects its specific context, objectives and priorities.

- **Funding approach:** This refers to the broad approach adopted in terms of the source of funding for ECE. Sources of funding can include public (either central government, state or local government or a mix of both), private (fully funded by service users and / or employers) or co-funded (a mix of public provision and user pays).
- **Funding type:** This refers to the general design features of the way in which funding is allocated. There are some key funding types with specific design features that are commonly used to fund ECE. These are described in further detail in the next section. Different funding types are typically used in combination with each other to form an overarching funding system. Each country or jurisdiction will have its own uniquely branded or named funding streams or programmes, but these generally be categorised as a particular funding type.
- **Funding mechanism:** This refers to the specific mechanics of how funding is calculated and delivered. Examples here include bulk funding, contracts or service-level agreements, vouchers, subsidies or reimbursements.

Funding types

9. In contrast to the attention paid to health system funding (see **Appendix 1** for a health system funding typology), there is relatively limited existing literature focused on frameworks for the funding of early learning and childcare settings. Drawing on what is available, the following key funding types for ECE services can be distinguished¹:
 - a. **Activity-based:** Activity-based funding (ABF) involves the classification and provision of funding in line with the cost of certain activities. The funding allocated is typically directly proportional to the level of activity (e.g. enrolments) that providers deliver. It is usually based on the estimation of the unit cost of defined activities or by methodically classifying, counting and defining the cost of certain activities.
 - b. **Block-based:** services are funded directly via lump sum payments. Funding is not necessarily attached to enrolments, attendance, or a specified level of activity, making it most useful for providers where costs are relatively fixed or more certainty of funding is warranted. Typically estimated using detailed cost data to identify the efficient cost of providing the service.
 - c. **Individualised:** funding supports parental autonomy to select the ECE services that best meet their needs. Funding rates or amounts are typically estimated based on analysis of what is reasonable and necessary to support the consumer's needs (e.g. cost of service delivery, level of support necessary to support participation). They can also vary to reflect household needs and circumstances (e.g. ability to pay fees; employment status). Funding can be direct to the service user or the provider. Individualised funding approaches are generally demand-driven (see below) so as to maximise consumer choice and decisions regarding ECE participation.
 - d. **Needs-based:** resourcing targeted to service providers based on characteristics associated with disadvantage, demonstrated need or adverse outcomes. Higher levels of funding (loadings or top-ups) are provided to support services to meet additional needs.

¹ [ecec-funding-models-and-levers.pdf](#)

Can be applied to population or community characteristics (e.g. disadvantage) individual qualities (e.g. a disability) or be service-specific (e.g. location, isolation).

- e. **Programme-based:** funding is provided for targeted programmes or initiatives to support the achievement of particular policy objectives. It is usually an additional funding stream alongside recurrent funding streams and may be provided for a set period of time.
 - f. **Outcome-based:** funding based on a provider delivering well-defined outcomes, with less specification (and monitoring of) of the nature of services to be provided. Generally used to incentivise higher provider performance and / or support innovative approaches to service delivery.
10. Funding for ECE can be provided on a **universal** or **targeted** basis. Some funding types (e.g. block-based) lend themselves more readily to universal funding provision, while others are by their nature intended to be targeted (needs-based, programme-based). Others (activity-based, individualised) can be designed to include both universal and targeted components).
11. Funding can be provided on either supply-side or demand-side basis. Supply-side and demand-side each consider whether the funding is intended to support services and service provision (supply), encourage participation or enrolment (demand), or both.
12. **Supply-side** funding is allocated directly to service providers. It includes direct public provision of services, and capital or operating grants or subsidies to providers, to cover the cost of service delivery. **Demand-side** funding usually paid to individuals but can be paid directly to providers on their behalf, and includes payments such as childcare fee subsidies and rebates. It is generally allocated based on where and for how many hours children are enrolled in ECE.
13. There is not always a clear-cut distinction between these two approaches. In particular, there are many examples of **demand-driven supply-side funding**, whereby providers receive direct funding (supply-side) underpinned by demand-side factors (e.g. numbers and characteristics of children enrolled).
14. Other design considerations for different funding types and mechanisms include the **conditions and controls** placed on the receipt and use of the funding. In a co-funded approach to ECE funding there may be controls in place to limit the cost to parents via direct or in-direct price controls. **Direct price controls** determine or limit the amount that ECE providers can charge parents (e.g. by requiring the provision of a free service for a certain number of hours in defined period, or by stipulating that parents can be charged no more than a certain percentage of the operating cost of care²). Examples of **indirect price controls** include levies on excess provider profits (as these disincentivise excessive fees), and 'caps' on demand-driven subsidies but are intended to influence fees but do not restrict providers' ability to charge parents above the subsidy cap.

Purposes, advantages and disadvantages of different funding types

15. An overall funding system is generally comprised of number of complementary funding types which, in combination, are designed to meet the goals and objectives of the system.
16. Some types are more effective than others in supporting the achievement of specific government objectives for ECE. The design of the overall system, and the funding types and mechanisms within it will create different incentives and have different impacts on provider

² www.accc.gov.au/system/files/childcare-inquiry-final%20report-december-2023_0.pdf

and parents' behaviours. In this sense, funding is used as a 'lever', alongside other policy levers such as governance structures, regulation, information provision and accountability. Additionally, each funding type has advantages and disadvantages. It is possible to mitigate disadvantages through careful attention to the design of the funding mechanism and the system as a whole (e.g. by adopting multiple mechanisms that work together in a coherent and complementary way).

17. These are all important considerations when determining which funding type to adopt in order to achieve a specific objective, and how different funding streams work together as a system. The following table summarises the kinds of purposes and objectives that different funding types are best utilised for, and some of their advantages and disadvantages.

Table 1: Purposes, advantages and disadvantages of different funding types

Funding Type	Best used to support...	Advantages	Potential disadvantages
Activity-based	ECE participation by all children Market-led approach to provision Provider responsiveness to both parent demand and government priorities (e.g. quality)	Funding reflects costs (estimated, average or actual) Efficient as funding is proportional to level of activity Clear, transparent basis for the funding provided Incentivises providers to increase level of activities in response to demand. Providers can be incentivised to support objectives (e.g. access / participation / quality) via variable funding for activities / cohorts	Relies on accurate costing of activities and regular adjustments Relies on the effective measurement and collection of activity-based data Funding uncertainty as dependent on volumes / level of activity Risks to service viability / ECE access if safeguards not in place in thin markets Doesn't take account of economies of scale Detailed activity reporting can create administrative burden on services (can be addressed via effective / automated IT tools).
Block-based	Universal access to ECE in all communities Predictable funding levels over time (not demand-driven)	Provides funding certainty for providers Supports service provision / access in face of low and variable demand Provider flexibility in how funding is allocated as not tied to certain activities.	Relies on information about how costs vary with service characteristics (e.g. size, location) Funding not directly tied to activities or outcomes so requires performance frameworks and monitoring Potential for inefficiency (e.g. supporting services with low enrolments) Little incentive for providers to innovate or respond to user needs
Individualised	Market-led approach to provision Consumer choice / agency Provider responsiveness ECE access and affordability for specific cohorts (e.g. low income)	Encourages service responsive to demand and parent preferences re quality and price Funding is tailored to different individual / family circumstances and diverse needs (not 'one-size-fits-all')	Parents require information to make informed choices Risks to ECE access in thin markets Relies on robust regulatory settings to manage market entry and ensure quality of provision Usually needs to be complemented by other funding to ensure service delivery can be maintained, with risk that adds complexity Application processes can act as a disincentive to participation.

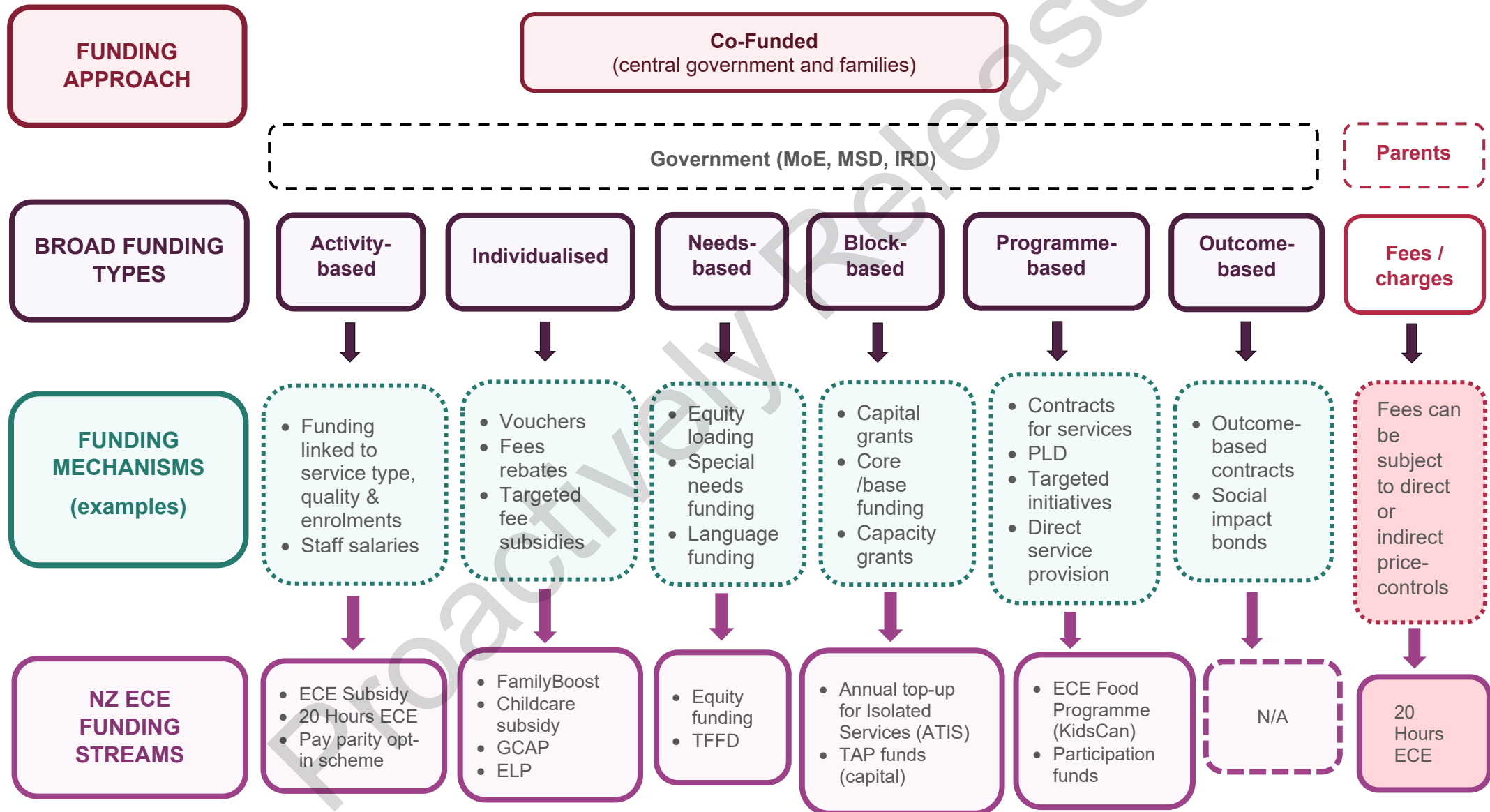
Funding Type	Best used to support....	Advantages	Disadvantages
Needs-based	Equity objectives (access, participation, outcomes) Effective services for those with additional needs The provision of services that meet diverse cultural and language needs of the population Te Tiriti partnership obligations	Recognises additional costs associated with providing services for some groups of children Compensates for limited resources in some communities Supports culturally and linguistically diverse services that might not otherwise be viable	Requires effective approach for assessing and targeting need and disadvantage Additional loading / top-up must be sufficient to enable services to address needs Scale effects mean smaller services may not receive sufficient funding Relies on services effectively utilising additional funding to address needs
Programme-based	Tightly-focused / specific policy priority (e.g. participation, literacy, teacher capability) that supports wider objectives Piloting or testing of new initiatives	Effective way to pilot / trial new initiatives Implements interventions that may not be part of usual provider activities Can be tightly targeted or focused on specific service types / communities	Funding may be time-limited, with lack of pathway for sustaining or scaling up the programme May be small-scale and not available to all services / children who might benefit Funding may go to 3rd-party to provider, adding complexity for ECE services
Outcome-based	Innovative service delivery models Incentives on providers to improve performance / outcomes	Provides incentives for services to innovate and lift performance in order to achieve outcomes Focusing on outcomes can achieve better value and impact of government funding	Detailed collection of outcomes-based data is necessary, with associated compliance costs Outcomes can be challenging to measure and / or attribute to specific services / interventions Can create perverse incentives and unintended consequences Outcome-based component of overall funding must be sufficient to incentivise performance. Service sustainability may be impacted if a proportion of funding is withheld subject to outcomes being achieved.

New Zealand's ECE Funding System (funding approach, types and mechanisms)

20. New Zealand has co-funded ECE system, with government and parents both contributing funding for services that supports provision from a mix of for-profit and not-for-profit providers. The following diagram uses the framework outlined above to present the broad funding approach and key government funding types and mechanisms that make up New Zealand's ECE funding system. It focuses on funding and does not include regulatory roles.

Diagram 1: Overview of the NZ ECE Funding System

The policy and operational **framework** for allocation and management of financial resources. Comprised of the overall funding **approach**, the broad **funding types**, the specific funding **mechanisms**, and design of a country's unique **funding streams** within these)



Funding can be demand-side, supply-side (or demand-driven supply-side), It can be provided in different ways (e.g. grants, payments, reimbursements) at different intervals (annual, quarterly, monthly), to individuals, services or another party (e.g. teachers, programme providers), with various conditions and controls attached.

21. The following table provides information about where the current ECE funding streams fit within the funding typology outlined above. As outlined in Table 1, different funding types are suited to different purposes and policy objectives.

Table 2: Type and mechanisms used for New Zealand ECE funding streams

Funding stream	Funding type	Mechanism	Intended purpose	% of Govt ECE funding
ECE Subsidy	Activity-based	Universal supply-side demand-driven subsidy to providers; calculated per child place; variable rates for service types, age-group ratios, % of qualified staff	Support broad participation in ECE, in line with child development and labour market participation purposes Incentivise service quality	41.3%
20 Hrs ECE	Activity-based	Universal supply-side demand-driven full subsidy with price controls for children aged 3-5; calculated per child, variable rates for service types, % of qualified staff.	Supporting broad participation in ECE by 3- and 4-year-olds (by further reducing cost to parents), in line with child development and labour market participation purposes.	46.9%
Equity funding	Needs-based	Multiple equity funding streams to eligible providers to address different needs. Equity funding for disadvantage is a loading on subsidy funding per child hour. Equity funding for isolation is a set grant .	Equity objectives (socio-economic disadvantage; special needs; languages and culture other than English; geographically isolated locations)	2.3%
Targeted Funding for Disadvantage (TFFD)	Needs-based	Top-up / loading on per child subsidy amount for services with higher % of disadvantaged children. Defined as the 20% of children who have spent the largest portion of their life as the dependent of a beneficiary.	Equity objectives (effective services for children from disadvantaged backgrounds)	0.4%
Childcare subsidy, Guaranteed Childcare Assistance Payment (GCAP) and Early Learning Payment (ELP)	Individualised	Targeted fees subsidy. Eligibility and amount (up to per hour maxima) based on family income, parental activity, and hours of ECE. Paid to providers.	Support parental employment and ECE participation by reducing ECE costs for low-income households	5%
FamilyBoost	Individualised	Rebate to parents of percentage of ECE fees	Provide financial assistance for low	4%

		paid (up to specified maxima). Amount rebated dependent on parental income.	and middle-income families paying ECE fees Supporting ECE participation by reducing ECE costs to parents	
Annual Top-Up for Isolated Services (ATIS)	Block-based	Annual grant payment to eligible small services based on geographic isolation.	Support ECE provision in isolated locations	Negligible
Discrete participation funds	Programme-based	Small-scale funding grants and contracts , including capital contributions	Equity objectives (increase participation in ECE by priority / under-represented groups)	Negligible
ECE food programme	Programme-based	Contract with third-party provider to deliver service (lunches) in eligible ECE services	Equity objectives (educational, health and social)	Negligible

Discussion / key takeouts

22. Funding systems are usually comprised of a number of complementary funding types which, in combination, are designed to meet the goals of the system. This is because no single funding type will be effective in achieving the range of goals and objectives that the Government is likely to have for ECE. Funding systems can also reflect a build-up of funding types over time without necessarily having regard to their complementarity.
23. The design of each funding type will have different impacts on provider and parents' behaviours. Different funding types and mechanisms can be used as 'levers' (alongside regulatory, accountability and other levers) to incentivise desired behaviours or outcomes.
24. There are advantages and disadvantages to each funding type. Disadvantages can be mitigated by pairing them with complementary alternatives. However, the more funding types that are included in the overall funding system, the greater potential there is for undue complexity and risks of perverse or unintended effects on providers or end-users.
25. ECE funding systems often have one funding type as the core 'building block', with smaller amounts of funding channelled through other funding types to build up overall quantum of funding.
26. The New Zealand ECE funding system is mainly comprised of three different funding types (activity-based, need-based, individualised), with limited use (and amount) of block-based and programme-based funding. Outcome-based funding is not currently used.
27. Funding can be provided directly to services (supply-side), or to service users (demand-side) or through a hybrid approach (demand-driven supply-side) in which the funding to services is determined on the basis of demand (e.g. enrolments). The approach used should be based on whether the intention is to support services and service provision (supply), encourage participation or enrolment (demand), or both (demand-driven supply-side).
28. The predominant funding mechanism used in the New Zealand ECE system is demand-driven supply-side funding provided direct to providers via grants and subsidies. A smaller amount of funding is delivered via demand-side provision, paid to individuals (FamilyBoost) or providers to subsidise ECE fees otherwise payable by parents (Childcare Allowance). Price control mechanisms are in place for the 20 Hours ECE subsidy.

29. As outlined in the MAG Terms of Reference, government funding for ECE in New Zealand is intended to support two main purposes:

- Supporting child development, to provide educational outcomes, while also supporting a strong foundation for learning and good life outcomes.
- Enabling parental/caregiver participation in the labour market to support families with the cost of living.

30. The ToR further notes that in order to deliver on these key purposes, funding needs to contribute to an ECE system that supports high quality education provision and learning, the health, safety, and well-being of children, and parental choice. Government goals noted for ECE include: ensuring children are as well prepared for school as possible; managing ECE affordability for parents/caregivers; and minimising barriers to labour market attachment.

31. An important consideration for the MAG is the extent to which current funding types (and the amount of funding channelled through them) are appropriately utilised to support the intended purposes and goals of ECE. Questions the MAG may wish to consider:

- What funding type(s) most effectively and efficiently deliver, incentivise, or enable the achievement of the Government's goals for ECE?
- What mix of funding types is needed to best meet both educational and labour market participation goals?
- What proportion of funding should be delivered through each type of funding? Have we got the balance right across them?
- Is the current funding system best characterised as coherent or fragmented?
- Are there currently too many funding types, mechanisms and streams in New Zealand? Can they be simplified or consolidated while still supporting the dual purposes and multiple Government's goals for ECE.
- Are we using the right funding types to achieve their intended purposes?

Appendix 1: Typology of government funding for health services

This Appendix presents a high-level overview of health system funding, to provide a contrast with early learning funding arrangements.

In general, health funding arrangements both in New Zealand and overseas display more complexity than ECE. This is due to factors such as:

- multiple types or levels of health services (i.e. primary care, hospital care, ancillary services such as pharmaceutical, imaging and laboratory testing).
- More diverse provider arrangements, ranging from providers that supply only one type of health service (e.g. primary care) through to others that provide all levels of services. In some cases, the same organisation can both fund and provide services.
- A larger and more variable population (including in age and diversity of health needs) served by the system.
- The use of insurance, which raises matters of regulation and calculation (e.g. the minimum benefits for those within a scheme, and risk factors used to adjust cost). We do not discuss insurance in any detail here, as the lack of a risk basis in ECE precludes the application of an insurance-based approach.

A typology of funding arrangements for health systems (including internationally) encompasses the dimensions outlined below.

A) Funding approach for the population.

Funding coverage by a healthcare system may be:

- Automatic and fully resourced by the state (e.g. if a resident, then funding and coverage is available)
- Compelled, in the sense that a person or household must pay a premium (insurance) or contribution
- Voluntary, with optional premiums or contributions paid by the person or household.
- A mixture, with contributions from users in conjunction with state-provided funding.

The approaches above can mean that user contributions are either:

- Free at the point of care (nil contribution)
- Require a certain percentage/amount of co-payment per event (e.g. visit) or item (e.g. prescription)
- As above but co-payment exemptions or partial exemptions apply based on certain criteria (e.g. certain health conditions, a maximum amount paid, age, income).
- Involve a co-insurance payment percentage
- Payment upfront but reimbursed later (e.g. via tax credits/deductions)

B) Healthcare delivery

Funding may support provision through:

- a national health system i.e. covering the entire country
- regionally-based health systems

- a single insurance fund and associated company
- multiple insurance funds and associated companies

Funding can enable the following provision types:

- Primary care provided through sole practices, group practices with multiple specialisations or single specialisation.
- Community-based outpatient specialist services, which can be private sole or group practices, public clinics or hospital-based outpatient clinics.
- Public hospitals, private (both not-for-profit and for-profit) hospitals.

C) Payment mechanisms

The following table outlines the key funding methods used in health systems. Across an entire health system it is likely that a mix of these methods will be used.

Funding method	Features	Pros (why to use)	Cons	Similar ECE funding type
Fee for service (FFS)	Providers are paid for each service delivered (e.g., consultation, test, procedure).	Demand driven so encourages service provision and responsiveness. Easy to understand, if not implement. Suitable for low volume use services.	Incentivises overuse and unnecessary procedures. Can lead to fragmented care. Difficult to control costs.	Activity-based
Per diem	Payment for each a day a patient is cared for. Usually based on an average patient cost for the service type.	Simpler to administer than FFS. Provides more predictable funding.	Doesn't target improved outcomes. May lead to longer stays than necessary.	Activity-based
Capitation	Providers receive a fixed amount per enrolled person, regardless of how many services or procedures are used or offered. Funding offered can be adjusted for risk factors eg, gender, prior use of services	Incentivises cost containment and preventive care Supports predictable budgeting for purchasers. Supports integrated care models (same patient, but in different settings and needs)	Risk of under-provision or patient selection. May reduce provider responsiveness. Requires strong monitoring systems including to set appropriate funding per enrolment.	Block-based
Salary	Individual providers are paid a fixed wage, typically in public systems	Stable income Simplifies administration. Reduces incentives for overuse.	May reduce productivity or innovation. Weak link to performance or outcomes. Less flexible in dynamic environments	Block-based?
Diagnosis-related groups (DRGs)	A provider (usually a provider such as a hospital) is paid a fixed amount per case, with cases coded into a group based on diagnosis and severity	Encourages efficiency and cost control Standardizes payments across providers Reduces unnecessary hospital stays.	Requires robust data and classification systems, including for benchmarking price. May discourage treatment of more complex cases. Risk of hospitals upcoding or gaming the system	Activity-based

Global Budgets	Providers (typically hospitals) receive a fixed total budget for a period.	Strong cost control. Encourages long-term planning. Reduces administrative burden (for the funder)	Limited flexibility to respond to demand. May lead to rationing or waiting lists. Weak incentives for quality improvement. Significant administration for provider to manage within cap.	Block-based
Line-item budgets	Specific version of above separated into funding for different specialties or services.			Block-based
Outcomes/ Performance-based	Providers receive payments or top-up bonuses for meeting specific quality or efficiency targets.	Aligns payment with health outcomes Encourages innovation and improvement Can complement other payment methods.	Risk of gaming or focusing only on measured indicators May neglect unmeasured aspects of care Requires reliable performance data.	Outcome-based
Bundled Payments	One payment covers all services for a defined episode of care (e.g., surgery + rehab).	Encourages coordination and efficiency Reduces fragmentation Aligns incentives across providers.	Complex to design and implement Risk of under-provision or cost-shifting Requires clear definitions and data systems.	Activity-based? (with elements of outcome-based)
Population-Based Payments	Providers receive a budget to care for a defined population, often with [health] outcome-based adjustments.	Supports integrated, preventive care Aligns incentives with population health Encourages innovation and flexibility.	High complexity and data requirements Risk of under-service or adverse selection Requires strong governance and accountability.	Needs-based (with elements of outcome-based)

Note payments may be made at different points (e.g. prospectively, as incurred, or retrospectively)

D) Funding cost drivers

The types of costs reflected in payments may include:

- The costs of the actual activity (e.g. by surgical procedure)
- Capital funding
- Health research and development
- Education and training of health staff

Payments can be integrated for providers that have control of different healthcare services or multiple healthcare types.

E) Setting prices for users

Prices (fees) for healthcare users (patients) may be charged through any of the following:

- by price negotiations i.e. as part of contract discussions between purchaser and provider (prices may be differentiated, for instance, locally, centrally and through use of a scale of relative values)
- determined by the central purchaser or government either based on a relative scale or standalone decision.
- Set by the provider (e.g. fees charged to the service user)

F) Determination of funding to the provider

Funding levels may be set through:

- Unilateral central decision (usually the government or purchaser representative of the government)
- Negotiation between government purchaser and provider or groups of provider representatives.

G) Resource allocation

Funding for health services may be:

- Restricted to a ceiling for the publicly-funded health budget (as in New Zealand).
- Restricted to fixed spending ceilings for specific components, schemes or entities (also used in New Zealand via appropriations capping agency spending)
- Ceilings may be hard capped, soft capped (an estimate) or unlimited (demand driven).
- Expenditure limits may be set by one or more agents – Parliament, central ministry or local authority etc.

Management of pressure on funding ceilings may be through a range of mechanisms, including:

- Additional appropriation of funding
- Use of reserve funds
- Spending freezes
- Deficit funding
- Funding rate decreases
- Rationing or reduced procurement e.g. of medicines
- Fee and co-payment increases.